

Chapter II

Audit Scope and Approach

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Introduction

In this chapter of the report, we provide an overview of the audit process. Included is information relating to the audit objectives and how they were met, the audit schedule, and the deliverables we provided to the Commission Staff during the course of the audit.

The Barrington-Wellesley Group, Inc. (BWG) performed the SBC/Ameritech Merger Investigation in accordance with the terms of a February 25, 2000 contract (Contract) with the Illinois Commerce Commission (ICC or Commission). During the course of the audit the Contract was amended three times, including two amendments to provide for changes in scope and schedule that were needed to respond to problems that were not anticipated at the time we began the audit. The audit was planned and performed in four distinct phases as summarized in Exhibit AS-1 below. The schedule information in this exhibit shows a comparison of the original plan with the schedule as the audit was actually accomplished. Reasons for the schedule changes are discussed later in this chapter of the report.

Exhibit AS-1
Phases of Investigation and Schedule

Phase	Description	Original Schedule	Actual Schedule
1	Planning and Orientation	March 22 through May 5, 2000	March 22 through May 5, 2000
2	Technical Review	May 8 through August 18, 2000	May 8 through November 17, 2000
3	Draft Report	September 8, 2000	December 15, 2000
4	Final Report	September 29, 2000	January 8, 2000

Audit Scope and Objectives

The SBC/Ameritech Merger Investigation was performed in accordance with Generally Accepted Government Auditing Standards applicable to performance audits (GAGAS). These standards are set forth in the booklet entitled *Government Auditing Standards, 1994 Revision*, promulgated by the Comptroller General of the United States. Because of its color, this booklet is often called the *Yellow Book*. It is now available on the General Accounting Office web site, with revisions through July 1999.¹

The Yellow Book standards pertain to auditors' professional qualifications and, among other things, require that the audit be carefully planned and performed in accordance with a written work plan. A more complete discussion of GAGAS is provided later in this chapter of the report.

In its Request for Proposals (RFP) relating to the audit and in the Contract, the Commission established broad objectives for the audit as follows:

¹ The Yellow Book may be accessed at <http://www.gao.gov>.

3. Determine whether an updated Cost Allocation Manual (CAM) appropriately allocates costs between Ameritech Illinois and its affiliates and between regulated and non-regulated activities.
4. Develop accounting standards and assist the Commission in tracking merger-related costs and savings as determined by the Commission's Order approving the merger of SBC and Ameritech.

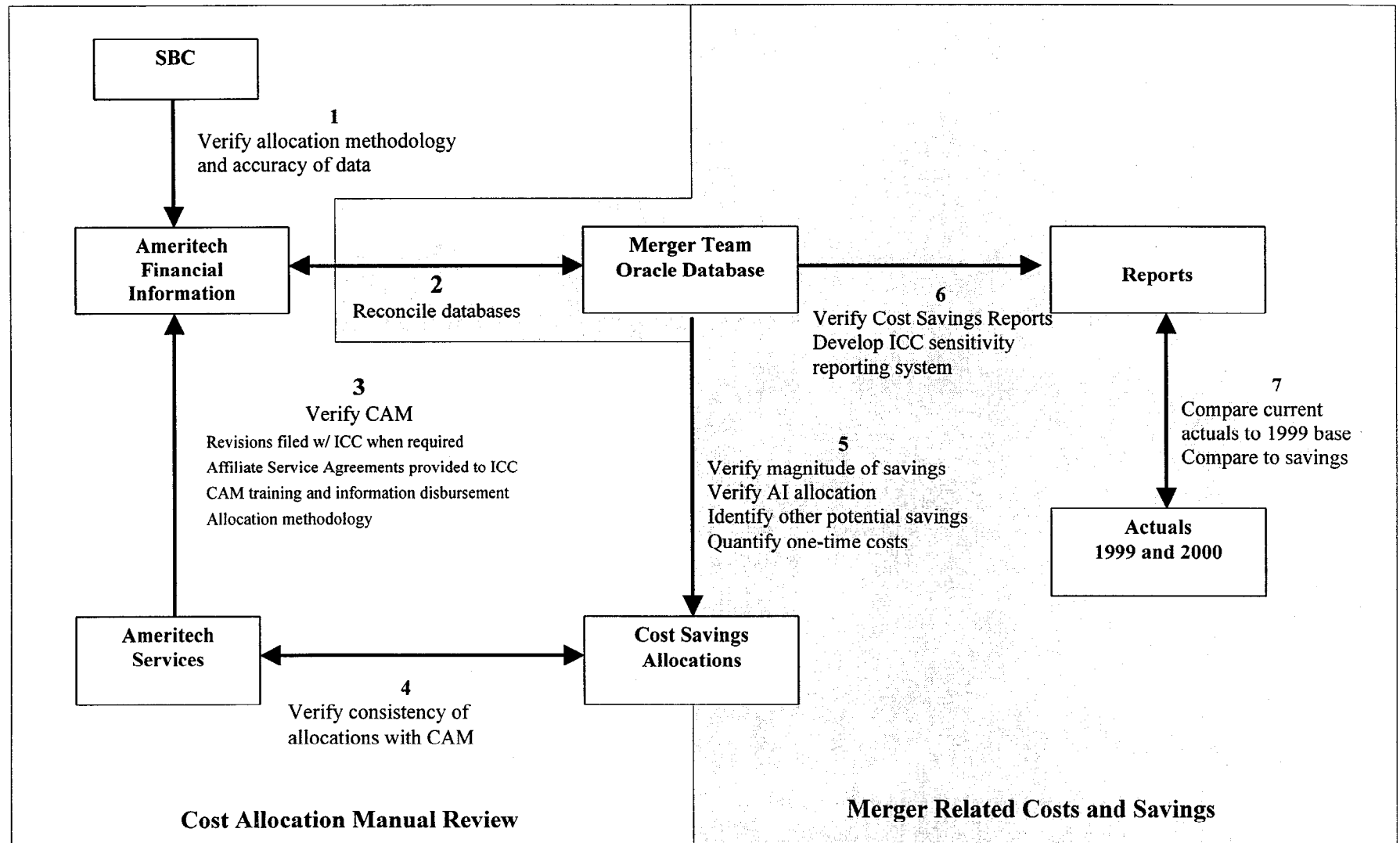
Detailed Work Plan

At the conclusion of the Planning and Orientation Phase of the investigation we prepared a Detailed Work Plan that was delivered to the Commission Staff on May 19, 2000. As stated in the Contract, the Detailed Work Plan is for the purpose of providing BWG and the Commission Staff with a written document to ensure that all necessary issues and subjects are adequately addressed in the investigation. In preparing the Detailed Work Plan, we attended presentations made by SBC/Ameritech personnel during the week of April 3, 2000, conducted follow-up interviews that week and during the week of April 24, 2000, and reviewed documents and other information provided in response to approximately 67 initial document requests. The Detailed Work Plan reflected our understanding of the Commission's requirements for the merger investigation and described our approach to the Technical Review in two major areas: 1) Cost Allocation Manual and 2) Merger Related Costs and Savings. As discussed further below, information obtained during the course of the audit necessitated some modifications to our approach in the review of Merger Related Costs and Savings.

A general overview of the audit process is shown in the diagram on the page that follows (Exhibit AS-2). The steps identified in this exhibit became the basis for the tasks identified in each audit area in the Detailed Work Plan. A summary of the audit work performed in each of the technical review areas is included in each subsequent chapter of this report.

The final work plan and budget for the project provided for a total of 5,500 hours of audit effort. During the audit we received responses to more than 750 formal requests for documents and other information, and conducted approximately 55 individual interviews with SBC subject matter experts and 35 merger team interviews. We also met on several occasions with Company representatives and Commission Staff to review and discuss the information we received relating to our verification of the Company's merger cost and savings process, and to review comments on task reports provided to the Company for verification.

**Exhibit AS-2
BWG Audit Process**



Changes in Audit Scope and Approach

During the course of the audit, we modified our approach to the work outlined in the Detailed Work Plan in the Merger Cost and Savings segment of the audit. As the Company itself was continuing to evolve and develop its approach to the determination of merger costs and savings, BWG's audit work required some refinement from that contemplated at the time of the Detailed Work Plan. Major changes from the Detailed Work Plan were documented in revised work plans that supported contract amendments executed on September 29, 2000 and December 7, 2000.

Modifications to BWG's Approach for Merger Integration Team Process Review

In June 2000, the Company advised BWG that all of its merger cost and savings calculations for the year 2000 to date were preliminary and could not be provided to us for verification.ⁱ This required that we focus on the process established by the Company rather than on the actual cost and savings amounts being tracked in the merger team database as was originally contemplated in the Detailed Work Plan. This change in the approach to the verification of the SBC Merger Integration Team process was addressed in the September contract amendment which also extended the date for completion of the audit from September 29 to December 31, 2000.

As more fully described in Chapter VIII of the report, as we proceeded with the Merger Team Process Verification work, we found that the documentation originally provided by the Company was not adequate for purposes of the audit. We addressed this matter in September, and agreed with the Company on an approach to obtaining the information we required. This process proceeded through October and November 2000, and was supported by the December contract amendment. This amendment also extended the date for completion of the audit to January 31, 2001 and established January 8, 2001 as the date for delivery of the final report.

Increased Focus on Pension Savings

During the course of the audit, BWG identified the need for increased analysis of the costs and savings associated with pension plan credits associated with the merger related termination of employees. To address this issue, BWG engaged an employee benefits expert to assist in the analysis of merger related pension savings. This engagement of the employee benefits expert was approved in the September contract amendment.

ⁱ The final determination of year 2000 merger cost and savings will not be available until the filing of the Company's report with the ICC on March 31, 2001.

Organization of the Report

The following briefly describes the contents of each chapter of the report.

- **Regulatory Compliance.** In this audit area, we focused on the Company's compliance with the conditions pertaining to merger costs and savings, cost allocation and internal compliance programs outlined in the Commission and Federal Communications Commission (FCC) merger orders as these orders relate to matters within the scope of this investigation.
- **Internal Controls.** In this audit area, we evaluated Ameritech internal controls pertaining to the organizations, systems and procedures established to ensure that affiliate transactions, cost allocation and merger related costs and savings are reported in accordance with the requirements of the Commission.
- **Affiliate Transactions.** Our work in this area included a review to determine that affiliate transactions are properly described in the Cost Allocation Manual and are supported by service agreements in accordance with the Commission's requirements. In addition, we performed tests to determine that affiliate transactions are priced in accordance with FCC regulations, and to determine whether there are material unrecorded and unreported affiliate transactions.
- **Cost Allocation.** In this audit area we reviewed Ameritech procedures and controls governing the cost allocation process. This included tests to determine that the cost allocation process documented in the CAM properly allocates costs between regulated and non-regulated activities, and that the results of the cost allocation process are properly reflected in the Company's ARMIS Joint Cost Report 43-03 filed annually with the FCC.
- **Recorded Cost and Savings.** In this area, we report on our tests of the 1999 Merger Costs and Savings information filed by SBC with the Commission on April 7, 2000. This chapter also contains our assessment of one-time merger costs that are not eligible for consideration as offsets to merger savings under terms of the Commission's order relating to the sharing of savings.
- **Merger Integration Team Analysis.** This chapter contains detail relating to our analysis of the work of the SBC Merger Integration Teams (MIT). It describes the MIT planning process including the format and structure of merger team recommendations and original savings estimates, the use of the merger tracking database, the process the Company is using to identify and quantify actual merger related cost and savings, and the process the Company plans to use for allocation of merger costs and savings to Illinois. It also provides our assessment of the Company's detailed cost and savings calculations for 35 selected savings recommendations or initiatives.
- **Additional Savings Possibilities.** This chapter describes the work we did to investigate potential savings possibilities that were not included in the merger integration team process. Areas of investigation include depreciation, taxes and interest. This chapter also

includes our assessment of merger team initiatives that the Company considers outside the scope of the audit and our assessment of potential pension expense savings.

- ***Early Warning System (Provided Separately)***. The Early Warning System is a set of spreadsheet models that we developed for use by the Commission Staff to monitor the Company's reporting of merger cost and savings against the Merger Integration Team plans, and to perform quarterly analysis. Discussion and documentation of our work in this area is in the form of a Procedural Manual relating to use of the models and was delivered to the Commission Staff in a separate report.

To the extent applicable, each of the Technical Review Area chapters includes the following sections:

- Background
- Audit Objectives
- Evaluative Criteria
- Summary of Audit Procedures
- Findings and Conclusions
- Quantified Results of Investigation
- Recommendations for the Company
- Policy Issues for the Commission
- Future Audit Issues

We use the caption Policy Issues for the Commission to highlight regulatory issues that should be resolved as soon as possible to provide the Company with guidance relating to the filing of subsequent year's annual Merger Cost and Savings Reports. Resolution of these issues will also narrow the scope of future audits by eliminating from consideration any contentious issues that have been resolved.

We also provide a summary of Future Audit Issues. These are specific issues that we believe need to be addressed in addition to the routine follow-up that will be performed to determine the Company's actions regarding the implementation of recommendations in this audit.

Generally Accepted Government Auditing Standards

The Yellow Book describes two types of Government Audits, namely Financial Audits and Performance Audits. The SBC/Ameritech Merger Investigation is a Performance Audit performed for the Commission for the general purpose of providing information to facilitate the Commission's regulatory oversight and decision-making regarding the Company's compliance with the Commission's requirements. The audit involves an objective and systematic examination of evidence for the purpose of providing an independent assessment of the Company's performance.

The Yellow Book codifies GAGAS pertaining to Performance Audits in three categories: 1) General Standards; 2) Field Work Standards; and 3) Reporting Standards. Standards in each area are described briefly below:

General Standards

General Standards include requirements concerning:

- **Qualification of the Audit Organization's Staff.** The staff assigned to the audit engagement should collectively possess adequate professional proficiency for the tasks required. To meet this standard, the audit firm should have a program in place to ensure that the audit staff maintains their professional proficiency through continuing education and training.
- **Independence of the Individual Auditor and the Audit Organization.** Auditors must be free of any personal or external impairments to independence. Internal auditors must additionally be organizationally independent. All auditors must maintain an independent attitude and appearance. Audit firms should document that the audit staff is free of personal impairments and that the firm is free of any external impairment.
- **Due Professional Care.** Due professional care should be used in conducting the audit and reporting the results of the audit. Exercising due professional care means using sound judgment in establishing the audit scope, selection of the proper methodology, the selection and conducting of the tests and procedures for the audit, and in evaluating and reporting on the audit results.
- **Participation of the Audit Organization in Quality Review Programs.** Audit firms must develop an internal quality control system and undergo an external quality control review at least once every three years by an independent reviewer.

Field Work Standards

Fieldwork Standards govern the overall conduct of fieldwork, including the planning and supervision of the engagement. Among others, Field Work Standards contain the following requirements:

- **Work is to be Adequately Planned.** In planning the audit, the auditors should define the audits objectives and the scope and methodology to achieve those objectives. The objectives are what the audit is to accomplish. Audit objectives can be thought of as questions that the auditors seek to answer. Scope is the boundary of the audit. It addresses such things as the period to be covered. Auditors should design the methodology to provide sufficient, competent, and relevant evidence to achieve the objectives of the audit. Methodology includes not only the nature of the auditor's procedures, but also their extent, for example sample size.
- **Written Audit Plan.** A written audit plan should be prepared for each audit. The plan should include an audit program or other appropriate documentation setting forth the key decisions about the audit objectives, scope, and the methodology and the auditors' basis for those decisions. The audit plan should be updated, as necessary, to reflect any significant changes to the plan made during the course of the audit.
- **Staff is to be Properly Supervised.** Supervision involves directing the efforts of auditors and others who are involved in the audit to determine whether the audit objectives are being accomplished. Elements of supervision include instructing staff members, keeping

informed of significant problems encountered, reviewing the work performed, and providing effective on-the-job training.

- **Compliance with Laws and Regulations.** When laws, regulations, and other compliance requirements are significant to the audit objectives, auditors should design the audit to provide reasonable assurance about compliance.
- **Management Controls.** Auditors should obtain an understanding of management controls that are relevant to the audit. When management controls are significant to audit objectives, auditors should obtain sufficient evidence to support their judgments about those controls.
- **Evidence.** Sufficient, competent, and relevant evidence is to be obtained to afford a reasonable basis for the auditors' findings and conclusions. A record of the auditors' work should be retained in the form of working papers. Working papers should contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditors' significant conclusions and judgments.

Evidence may be categorized as physical, documentary, testimonial, and analytical. Physical evidence is obtained by direct inspection or observation of people, property, or events. Documentary evidence consists of created information such as contracts, accounting records, invoices and management information on performance. Testimonial evidence is obtained through inquiries, interviews, or questionnaires. Analytical evidence includes computations, comparisons, and separation of information into components.

- **Working Papers.** Working papers serve three purposes. They provide the principal support for the auditors' report, aid the auditors in conducting and supervising the audit, and allow others to review the audit's quality. Working papers should contain 1) the objectives, scope, and methodology, including any sampling criteria used; 2) documentation of the work performed to support significant conclusions and judgments; and 3) evidence of supervisory review of the work performed.

Reporting Standards

Reporting Standards govern the overall reporting aspect of the engagement after the fieldwork has been completed.

- **Written Reports.** Auditors should prepare written audit reports communicating the results of each audit. Written reports 1) communicate the results of audits to government officials, 2) make the results less susceptible to misunderstanding, 3) make the results available for public inspection, and 4) facilitate follow-up to determine whether appropriate corrective actions have been taken. The need to maintain public accountability for government programs demands that audit reports be written.
- **Timeliness.** Auditors should issue reports to make the information available for timely use by management, regulatory officials and other interested parties.

- **Report Contents.** Auditors should report: 1) audit objectives and the audit scope and methodology; 2) significant audit findings and conclusions; 3) recommendations for actions to correct problems and to improve operations; 4) that the audit was made in accordance with generally accepted government auditing standards; 5) all significant instances of noncompliance and all significant instances of abuse that were found during or in connection with the audit; 6) the scope of their work on management controls and any significant weaknesses found during the audits; 7) the views of officials responsible for the activities that are the subject of the audit concerning the auditors' findings, conclusions, and recommendations as well as corrective action planned; 8) noteworthy accomplishments, particularly when management improvements in one area may be applicable elsewhere; 9) significant issues needing further audit work or analysis; and 10) if certain information is prohibited from general disclosure, the nature of the information omitted and the reason that the omission is necessary.
- **Report Presentation.** The report should be complete, accurate, objective, convincing, and as clear and concise as the subject permits.
- **Report Distribution.** Written audit reports are to be submitted by the audit organization to the appropriate officials of the auditee and to the appropriate officials of the organization requiring or arranging for the audit, unless legal restrictions prevent it. Unless restricted by law or regulation, copies should be made available for public inspection.

Project Deliverables

During the course of the audit, we provided the following specific and periodic reoccurring reports. To communicate with members of the Commission and the Commission Staff, we established a secure intra-net website where many of the documents delivered to the Staff are posted. The website is password-protected, and can be accessed by both project team members and the Commission Staff.

Specific Documents and Reports

- The Preliminary Audit Work Plan included in BWG's "Proposal for an Investigation of SBC/Ameritech Cost Allocations and Merger-Related Costs and Savings," dated December 31, 1999.
- The Revised Project Work Plan dated February 4, 2000, referenced in the Contract relating to the engagement dated February 25, 2000.
- Initial Information Request included in the Proposal and delivered to the Company for response during an initial logistical and administrative meeting held with the Company and Commission Staff representatives on February 28, 2000.
- BWG's Detailed Work Plan dated May 19, 2000.

- BWG Memo to ICC Staff dated July 11, 2000 regarding conceptual issues and Staff's response dated August 8, 2000.
- BWG Project Letter to ICC Staff dated September 7, 2000, regarding the MIT Process Verification and Pension Savings Analysis.
- MIT Process Verification Work Plan dated September 28, 2000.
- Document Requests issued by individual members of the BWG project team throughout the duration of the audit fieldwork.
- Requests for individual and group interviews with SBC/Ameritech employees.
- Interview summaries prepared to document discussions, identify documents requested, and summarize issues requiring follow-up or analysis.

Periodic Reoccurring Documents and Reports

- Informal Weekly Reports describing the schedule for interviews and meetings and other plans for the following weeks.
- Monthly Progress Reports describing project status, any problems encountered and plans during the following month.

Meetings with the Company and Commission Staff

- Discussed the audit work plan at the May 9, 2000 Commission Telecommunications Policy meeting.
- Discussed the status of merger cost and savings data for the year 2000 in a July 7, 2000 meeting with SBC and Commission Staff.
- Discussed the MIT Process verification approach in a September 29, 2000 meeting with SBC and Commission Staff.

Technical Review Area Task Reports

Upon completion of our audit investigation in each of the technical review areas, we prepared annotated Task Reports providing background information in the task area, describing our work and referencing the documents and other evidence supporting our findings and conclusions. The Task Reports were provided to the Commission Staff for review and released to the Company for verification in accordance with the schedule shown in Exhibit AS-3 below:

**Exhibit AS-3
Task Report Dates**

	Report to ICC Staff	Report to Company for Verification	Verification Meeting
Regulatory Compliance	6-29-00	9-14-00	10-11-00
Internal Controls	7-04-00	9-27-00	10-11-00
Affiliate Transactions	8-18-00	10-3-00	10-19-00
Cost Allocation	8-18-00	10-3-00	10-19-00
Reported Cost and Savings	10-13-00	11-9-00	11-29-00
Merger Integration Team Analysis	11-22-00	11-22-00	12-14-00
Additional Savings Possibilities	10-13-00	11-9-00	11-29-00
Early Warning System	10-13-00	11-9-00	11-29-00

The Company documented its comments on the Task Reports in Task Report Verification Letters. BWG responded to the comments in hand written notations on the Verification Letter attachments indicating the disposition of the proposed changes. Copies of these documents were provided both to the Company and the Commission Staff to document the changes made as the Task Reports were incorporated into the draft and final Merger Investigation Reports.

Project Schedule

The overall audit schedule is shown in Exhibit AS-4 and summarized in Exhibit AS-5 below.

**Exhibit AS-5
Audit Schedule**

Work Step	Completion Date
Phase I – Planning and Orientation	5-5-00
Phase II - Technical Review	
Cost Allocation Manual	
• Regulatory Compliance	6-29-00
• Internal Controls	7-04-00
• Affiliate Transactions	8-18-00
• Cost Allocation	8-18-00
Merger Costs and Savings	
• Reported Cost and Savings	10-13-00
• Merger Integration Team Analysis	11-22-00
• Additional Savings Possibilities	10-13-00
• Early Warning System	10-13-00
Phase III - Draft Report	12-15-00
Phase IV - Final Report	1-8-01

Glossary of Terms and Acronyms

Exhibit AS-6 provides a Glossary of Terms and Acronyms used throughout the Merger Investigation report. In general, acronyms are defined when first used in each chapter and used thereafter in their abbreviated state.

Exhibit AS-4 **SBC/Ameritech Merger Investigation Project Schedule**

Audit Work Step	April			May			June			July			August			September			October			November			December			January					
	3	10	17	24	1	8	15	22	29	5	12	19	26	3	10	17	24	31	7	14	21	28	4	11	18	25	4	11	18	25	4	11	18
Phase I - Planning and Orientation																																	
Phase II - Technical Review																																	
Cost Allocation Manual																																	
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Cost Allocation																																	
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Additional Savings Possibilities																																	
Early Warning System																																	
Phase III - Draft Report																																	
Phase IV - Final Report																																	

▼ Detailed Work Plan 5/19

▼ Task Report 6/29

▼ Task Report 7/4

▼ Task Report 8/18

▼ Task Report 8/18

▼ Task Report 10/13

▼ Task Report 11/22

▼ Task Report 10/13

▼ Task Report 10/13

▼ Draft Report 12/15

▼ Final Report 1/8

Exhibit AS-6
Glossary of Acronyms and Terms

AA	Arthur Andersen, LLP
AADS	Ameritech Advanced Data Services
ACAM	Ameritech Cost Allocation Manual
ACC	Ameritech Credit Corporation
ACI	Ameritech Communications, Inc.
ACPI	Ameritech Center Phase I
ADNS	Ameritech Data Network Solutions
AFIW	Ameritech Financial Information Warehouse
AI	Ameritech Illinois
AICPA	American Institute of Certified Public Accountants
AII	Ameritech International, Inc.
AIIS	Ameritech Information Industry Services
AIM	Ameritech Interactive Media, Inc.
AIMS	Ameritech Interactive Media Services, Inc.
AIS	Ameritech Information Systems
AIT	Ameritech Corporation
AMA	Automatic Message Recording
AMCI	Ameritech Mobile Communications, Inc.
ANM	Ameritech New Media, Inc.
AOC	Ameritech Operating Company
APB	Accounting Principles Board
API	Ameritech Publishing, Inc.
APSN	Ameritech Packet Switched Network
ARB	Accounting Research Bulletin
ARDS	Ameritech Rate Development System
ARMIS	Automated Reporting Management Information System
ASB	Auditing Standards Board
ASI	Ameritech Services, Inc.
B&C	Billing and Collection
BCATS	Billing, Collection and Tracking System.
BWG	Barrington-Wellesley Group, Inc.
CAM	Cost Allocation Manual
CDAR	Customer Dialed Account Recording
CFL	SBC Center for Learning

**Exhibit AS-6
Glossary of Acronyms and Terms**

CFR	Code of Federal Regulations
CIA	Certified Internal Auditor
CISA	Certified Information System Auditor
CMA	Certified Management Auditor
COSO	Committee of Sponsoring Organizations
CP	Cost Pool
CPE	Customer Premises Equipment
CT	Clover Technologies
DR	Document Request
DT	Don Tech
E&Y	Ernst & Young, LLP
E911	Enhanced 911 Services
ETDP	Enhanced Time Distribution Process
FASB	Financial Accounting Standards Board
FASC	Functional Accounting System Code
FCC	Federal Communications Commission
FDC	Fully Distributed Cost
FMV	Fair Market Value
FRC	Field Reporting Code
GAAS	Generally Accepted Auditing Standards
GAGAS	Generally Accepted Government Auditing Standards
GAS	Government Auditing Standards
GASB	Government Accounting Standards Board
IAS	Internal Audit Staff
ICAM	Illinois Cost Allocation Manual
ICC	Illinois Commerce Commission
IDR	Initial Document Request
IP/PI	Intellectual Property/Proprietary Information
IXC	Interexchange Carrier
MDS	Message Delivery Service
MIT	Merger Integration Team
MSI	SBC Management Services, Inc.
NARUC	National Association of Regulatory Utility Commissioners

Exhibit AS-6
Glossary of Acronyms and Terms

NCTE	Network Channel Terminating Equipment
NDA	National Directory Assistance Service
NTA	National Telecommunications Alliance, Inc.
OG&A	Other General and Administrative
OSS	Operations Support Systems
PAS	Personal Access Services
PCAS	Part 64 Cost Allocation System
PFA	Publicly Filed Agreements
PICC	Primary Interexchange Carrier Charge
PP	Prevailing Price
PSAP	Public Service Answering Point
PUA	Illinois Public Utility Act
RAO	Responsible Accounting Officer
RBOC	Regional Bell Operating Company
RFP	Request for Proposal
SAS	Statement on Auditing Standards
SBC	SBC Communications, Inc.
SBMS	Southwestern Bell Mobile Systems, Inc.
SBO	SBC Operations, Inc.
SBS	SBC Services, Inc.
SIC	Starline Insurance Company
SLA	Security Link from Ameritech
SOP	Statement of Position
TCC	Transaction Category Code
TELRIC	Total Element Long Run Incremental Cost.
TOE	Total Operating Expense
TPG	Transition Policy Group
TPIS	Telephone Plant in Service
UNE	Unbundled Network Elements
USOA	Uniform System of Accounts
VMS	Voice Messaging Services